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Abstract

We explore the trading decisions of equity mutual funds during ten periods of extreme market uncertainty. We find that mutual funds reduced their aggregate holdings of illiquid stocks. Exploring the drivers behind this result reveals that this is mainly driven by larger withdrawals from funds that hold less liquid stocks. We further find that the sell-off of illiquid stocks occurred only after initial deterioration in market conditions, consistent with retail investors' response to bad performance. At a broader level, this shows that mutual funds consumed liquidity during periods where liquidity was most valuable. Moreover, the fact that fund managers traded in response to these withdrawals suggests a potentially magnifying channel for the drop in illiquid stock prices, also known as flight-to-liquidity.

Key words: market uncertainty, financial crises, liquidity, flight-to-liquidity, flow-induced trading, mutual funds, institutional investors, liquidity provision, portfolio liquidation

JEL classification: G01, G11, G12, G14, G20

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